RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 •

POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

July 12, 1989 **LETTER 1021** **Weekly statistics on page 6.**

THE MARKET: Question: Twenty-one months have passed since the crash. Why, after all these months of booming business, takeovers and leveraged buyouts, is the Dow still around 220 points below its 1987 bull market high of 2722.42?

Answer: Because the bull market ended in August 1987, at which point the Averages discounted the best that could be seen ahead. Once a bull market ends, the bear takes over, and the Averages don't go to new highs in a bear market (although, of course, one Average, the Transports, did -- but one isn't enough).

The stock market is a strange and esoteric place, and events don't often progress according to Hoyle. For instance, the current stock market has been rising despite a host of warnings that would ordinarily have been the prelude to lower prices. Here's a brief listing:

(1) Yield on the Dow a low 3.5% and yield on the Transportation Average a minuscule 1.47%. These dangerously low yields have, so far, been ignored by the market.

(2) Major (primary) non-confirmation in that the Dow has still not confirmed the record high in the Transports. Also ignored by the market -- so far.

(3) Percentage of undervalued blue-chip stocks down to a dangerous 17% (under 17%, historically, has identified a top area). Also ignored.

(4) "Three-step-and-stumble" sell signals appeared a few months ago as the Fed boosted the discount rate for the third time. Ignored.

(5) Decline in daily new highs on the NYSE. On June 8, my 5-day moving average of daily new highs hit a peak of 226. From there it declined, then rallied to a much lower peak of 112 on June 27 (with the Dow at a new recovery high). This represented obvious technical deterioration. Ignored.

(6) A dramatic slump in the growth rate of the money supply (in the past this has always signaled recession). So far, ignored.

(7) The so-called "General Motors rule," which states that if four months go by without a new high in GM, the market is a "sell." A sell signal under this formula was touched off a month ago. Ignored by the market.

(8) IBM lag. IBM has been the market leader for years. But IBM has not been participated in the post-crash recovery, having done literally nothing since October 1987. Ignored.

(9) Utility lag. The Utility Average topped out of the bull market on January 22, 1987 at 227.83. It has not been back there since. The Utility Average tends to be a bellwether. Again, ignored.

If I'm correct, if all the action since October 1987 was an extraordinary post-crash correction (fueled by takeovers and massive leveraging), then the primary bear market is still in force -- even though it has been held back for 20 months.

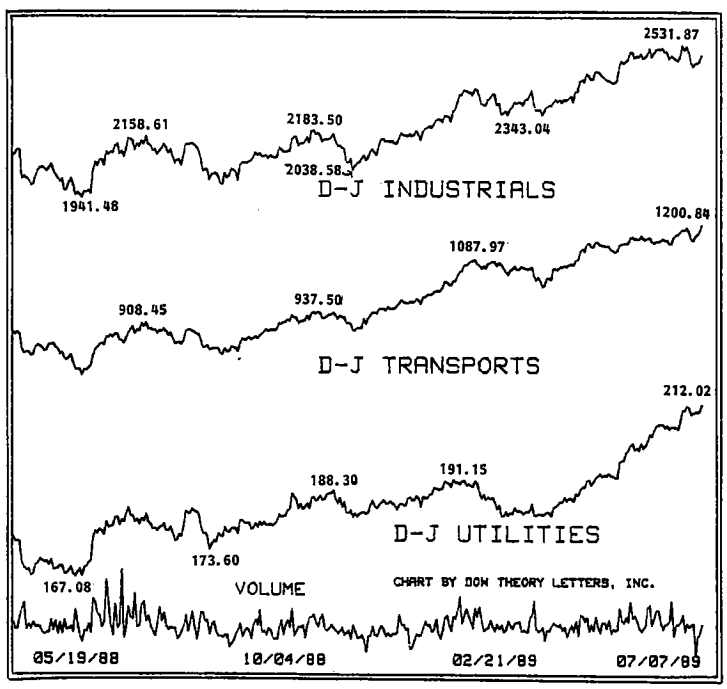
When the primary trend (bull or bear) is held back for whatever reason, it acts like a steel spring that has been put under pressure. Finally, the pressure becomes too intense and the spring expands -- but with extraordinary force. The same is true in the stock market. When the primary trend is held back, ultimately it is released and with surprising force. This should occur somewhere ahead.

THE PICTURE: I read and read, and I note that the following question is being asked by most of the astute minds on Wall Street. What are Alan Greenspan and the Fed trying to do? By now, most knowledgeable investors know that the brakes have been slammed on the US money supply. In fact, since mid-1988 the rate of monetary creation has literally collapsed. Ordinarily, this kind of squeeze would send the economy tumbling into recession. But optimism reigns on Wall Street and instead of recession warnings, we have widespread predictions of a "soft landing" or "no recession at all."

One thing I'm certain of is Alan Greenspan does not want to go down in history as the Fed chief who allowed inflation to heat up again (not after all Paul Volcker's painful anti-inflation work). But the fact is that inflation of around 6% or better stubbornly remains. In fact, the feeling is that if the US money supply was to expand strongly, or if interest rates were to plunge, inflation would soar again.

Sometimes, it pays to deal with the obvious. And it would seem the obvious is the Fed has wanted to create a mini-recession, a recession which would hopefully wring out whatever inflation exists in the economy. Then later (as is their pattern) the Fed would open the money spigots in time for the 1990 election, thereby creating happy-time for President Bush and the incumbents.

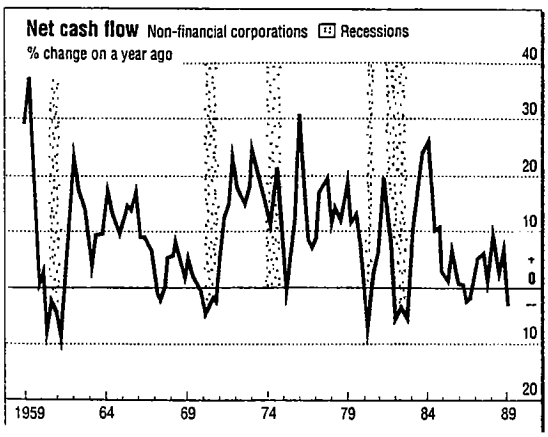
Will it work? Can the Fed produce a teeny-weenie recession? If it can, the theory is there will be less need for borrowing, and therefore interest rates will be heading happily downward. Furthermore, the decline in the stock market will be mild -- so



hey, why not jump the gun, skip the recession-valley, and get in early for the next stock market boom.

Well, that's the plan, and who's to say it won't work? But "there's many a slip 'twixt the cup and the lip," and it remains to be seen whether the above scenario is going to run its course without a hitch.

As I see it, there definitely is a hitch in the picture. The hitch is **DEBT, leveraged debt.** The US is up to its neck in debt, head-over-heels in debt, drowning in debt. In fact, right now debt repayment is absorbing 22.7% of total corporate cash flow (this is higher than the post-1945 record set in 1974), as this chart from the London *Economist* illustrates.



The *Economist* also warns, and I quote, "the interest payments' share of cash flow normally does not peak until the middle of a recession. This would suggest that the American economy is already in recession but nobody knows it yet -- or that the cash-flow squeeze on companies is going to get worse than in any of the previous post-1945 downturns. Watch out, junk bond investors."

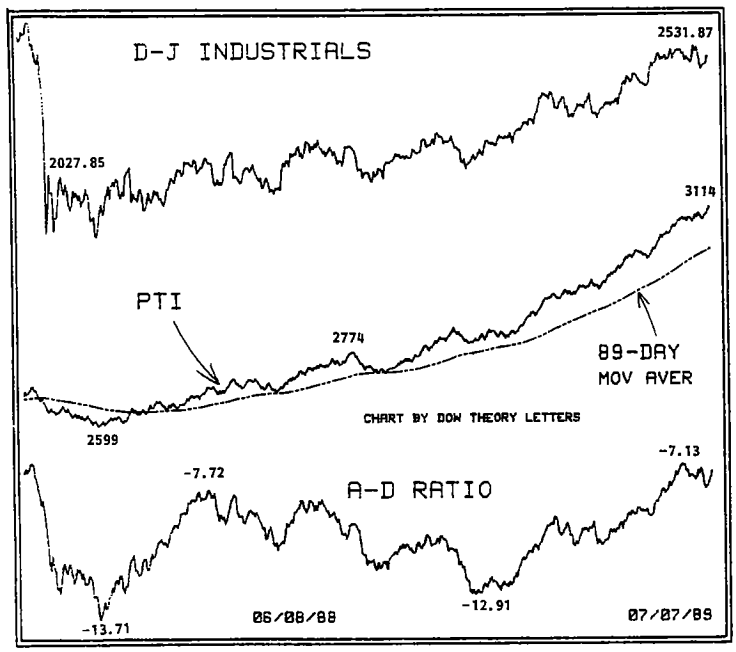
REAL ESTATE: This is the key. In my opinion everything now rests on the price structure of real estate -- the price of homes, apartment houses, condos, hotels, commercial buildings. That's where the nation's assets are (there are $2.4 trillion in residential mortgages out there). For the most part these mortgages are inflated in value (yeah, I know your broker doesn't agree).

Ultimately, everything comes down to return on the investment. In many parts of this nation, there is no return on real estate. Let me illustrate: if you buy a home for $200,000, it costs you 10% or $20,000 a year to carry that house (this amounts to $1,660 a month). If you are so bold as to want to make a profit you would have to charge rent of around $2,000 a month. Try buying a house for $200,000 and renting it for $2,000 a month. You can't do it. The rent is much too high. Which is another way of saying that the house is far too expensive -- it's selling at a price that will only give you a negative cash flow.

The fact is that today in 1989 it's far cheaper to rent than to buy. And as I said, ultimately, prices always come down to a reasonable return on the investment. If there is no return on investment, the price is too high.

The inflated prices of real estate underlie practically the whole financial structure of this nation. Behind the leverage in the US financial system lies the great collateral -- real estate. If the real estate price structure starts to crumble, there's going to be major trouble -- trouble you won't believe.

Already we can see some of the damage. The S&L mess was triggered by collapsing real estate prices (mostly confined to the Southwest). Now we hear about trouble at HUD (perhaps mostly mismanagement plus some outright scams). Then two weeks ago the *New York Times* headlined trouble at the Department of



Veterans' Affairs (VA) which now has to deal with almost 50,000 defaults. This in turn will impact Ginnie Maes. Obviously, the banks and the insurance companies are loaded with mortgages, and here again it's the price structure of the real estate market that is absolutely critical.

We know what happened in the Southwest. As home prices fell, many homeowners walked away. They realized that they could buy bigger houses for less than their current mortgage payments. They said, "The devil with the payments," and they walked. Others simply lost their jobs and walked. The net result was that hundreds of S&Ls went belly up (of course, many S&Ls went bankrupt due to poor management or just plain thievery). But one way or the other, they went.

I'll repeat it: I continue to feel that the US housing picture is one of the shakiest areas of the economy. Housing is where Americans have the great bulk of their savings and assets. If housing prices go, that could represent the difference between recession and depresssion.

INVESTMENT POSITION: A number of subscribers asked me why I have moved out of most of my investments and mostly into cash. The answer is that it was pretty much a personal decision and one you don't have to follow. If you own high-grade bonds, AA-rated or better, munis or otherwise, and you want to sit with them and collect the interest, I'd say fine, why not, do it. I

sold a lot of my bonds simply because I had very fat profits, and I couldn't resist nailing down some of those profits. My philosophy is that "the markets are always there," and values in new areas will always surface. I'm content now to sit with a lot of cash and wait. I'm very patient.

One thought: the "new" equation in today's market can be summed up in one word -- GLOBAL. For instance, foreigners now own tens of billions of dollars worth of US bonds. If our foreign creditors don't like what we're doing, if the dollar turns persistently weak, if the US economy buckles, if the US lowers interest rates too much, foreign holders could dump their bonds -- at which point interest rates here would surge. Remember, when you're a debtor,

your creditors call the tune. That's where the US is today -- unfortunately. Greenspan and the Fed know this, and it is one reason why they may not be quick to ease credit, regardless of what happens in the economy.

So I still like high-grade bonds (but not as much as I did a few years ago). And I continue to advocate fixed-dollar averaging in gold coins.

CHARTS: Each week I study hundreds of charts, and there are always a few that cause me to say, "I sure wish my subscribers could see these." So every once in a while I publish a collection of significant charts with my notations on them. Here's my latest group, and please study these carefully (see pages 4 and 5). Additional comments on these charts below.

The Japanese export chart is a shocker. Actually, Japan's trade surplus narrowed by 40% in May. Japan (which survives on exports) could be running into major trouble. The chart of the Nikkei (Japanese) stock average hints that an important top may be forming. Did you know that widely-distributed Nippon Telephone (the biggest capitalization Japanese stock) is down 62% from its high!

Gold divided by D-J 20 Bonds constitutes a good inflation/deflation barometer. So far, the direction is clear, and it's deflation. But more recently, gold has looked stronger. I'm watching for a breakout on this chart.

Everyone is certain that the dollar is in a big new bull market. Maybe, maybe not, but so far the dollar rally is a mere bounce off the bottom.

The chart of US corporate interest payments is crucially important. If we get a recession (or even a soft landing) America's mountain of interest payments is going to present a problem. And it's a problem that spells -- bankruptcies.

Is the spectacular spread (now 5.19%) between junk bond yields and Treasury bond yields telling us something? Roger Hoey of *Drexel Burnham* (as you know they're big junk bond sponsors) states that junk bonds are being priced "to fear and trembling" while Treasury bonds are priced to "nirvana." Obviously that kind of sentiment is what's giving us this wild spread on the yields. On the face of it, this kind of rocketing spread action represents a definite danger signal. The wider the spread, the greater the fear and the greater premium investors are paying for safety. Do junk bond sellers know something we don't know? We should know soon enough.

The foreign currencies are in major head-and-shoulder top formations. On the basis of the chart alone, you'd have to say that the German mark has topped out for the duration and that the dollar is heading much higher. But this is what everybody thinks, and I guess I'm just a little bit skeptical.

US money growth has caved in. The influx of foreign funds plus slews of corporate takeovers have masked the effects of the great money-growth collapse. Normally, this kind of action in the money supply would absolutely guarantee a recession. But a lot of foreign money has been coming in, and this clouds the picture.

Housing starts are heading down, as are car sales and sales of machine tools and durable goods. So far, the stock market hasn't taken it all that seriously. Maybe it knows something we don't know. Maybe there really will be a soft landing. Maybe a lot of things.

The federal deficit picture looks progressively worse. "Creative" cheating by Congress has masked much of the recent budget deterioration. It's incredible that President Bush has not called for honesty on the budget, but something seems to happen to people when they get to Washington. And it's seldom an attack of honesty.

Bank failures, S&L failures, insurance company failures. It's America in the 1980s, and "anything goes." As you can see on this chart, a lot of it is going!

The US savings rate is finally rising. This could mean that the US public is up to its ears in cars, homes, and appliances -- and they're finally putting money in the bank. Or it could mean that Americans are worried. That's a multiple-choice answer, but the chart shows that a long downward trend has been reversed. (Americans still save about a third as much as the Japanese, however.)

Charts marked "A" courtesy of Paul Eldridge of Howard Ruff's *Target Publishing*. Charts marked "B" courtesy of Ed Hyman and *C.J. Lawrence*. Charts marked "C" courtesy of John Pugsley and the *Common Sense Press*.

NOTES & QUOTES: "No Recession This Year or Next," states the July 7 issue of *Fortune* magazine in its monthly economic forecast. *Fortune* then predicts the "business outlook is relatively sanguine. Profits will pick up, albeit modestly. Unemployment will increase only a little. The terrible twin deficits, the one in Washington and the other with the trading partners, will shrink moderately. Interest rates will climb again by 1990, but probably not much beyond their winter highs. . . . But the Fed's ultimate objective and responsibility is to slow the pace of inflation, and that goal will elude it. With wage increases on an uncomfortable brisk upward trend, prices will climb an average of 5.5% or worse next year." Will it all happen as painlessly as *Fortune* predicts? I doubt it, but that's because I believe we're in an overall deceptive bear market.

* *

Wall Streeters in general have suffered a mini-depression since the crash. That includes most of them -- not all. A few hundred never had it so good. *Financial World* (July 11) (a vastly improved magazine, by the way) tells the astounding story. The top 100 made from $6 million to $180 million (median $15 million) last year. Then there is an honorable mention list of those who made only $3 to $6 million. What did the top guys have in common? They were mostly principals in their firms, and they were mostly involved with corporate takeovers. (I call the whole takeover process "the rape of corporate America.") Talk about rape, KKR and its investors made $990 million alone last year when they sold SCI Holdings. Bill Simon and Ray Chambers split $37 million on a single deal. Robert Bass made a $66 million personal profit on Macmillan. Paul Bilzerian made at least $80 million from the Singer asset sale. And so on.

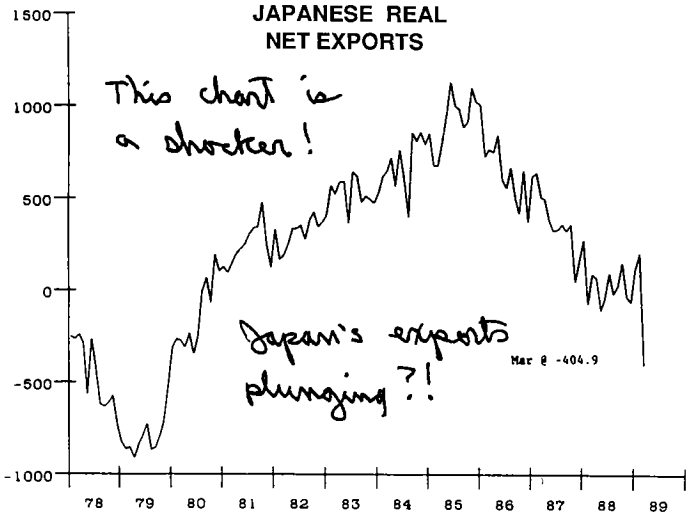
Another Wall Streeter who's not in a bear market is my old friend Marty Zweig. I knew Marty back in the days when we both were struggling. *Financial World* lists Marty as having made "at least $6 million" last year. The article goes on to state that Marty "just bought 14 mutual fund portfolios having a total of $2.8 billion in assets from Drexel" (yeah, I knew that). Then it adds that "Zweig just installed a $52,000 pool table on the third floor of his home." (Now I didn't know that. Who made that pool table, Marty, Chippendale?)

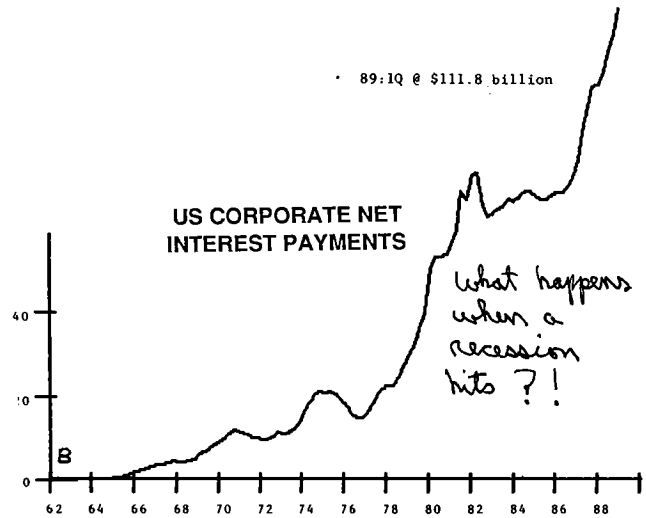
* *

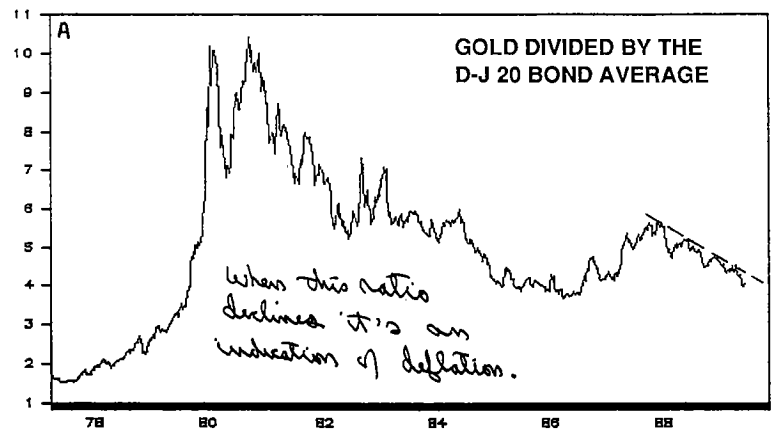
Quietly, Japan has become the third highest military spender in the world. Students of the military are worried about the US position. In purchasing the FSX, Japan has chosen to spend double what it would have cost simply to buy the US' F-16 fighters. It's obvious that Japan wants to absorb US advanced aerospace technology. Japan is already producing world-class rockets, radar-jamming equipment, fuselage parts and a guided missile with greater reliability than the much-touted French Exocet. Japan (as is her custom) is concentrating all her aerospace eggs in three companies with these three accounting for 70% of the Japanese aerospace effort. The concentration is part of Japan's method of producing results FAST. Japan is producing $7 billion worth of aerospace equipment now. *Booz Allen & Hamilton* predicts that by 1990 Japan will be producing $25 to $30 billion worth of equipment.

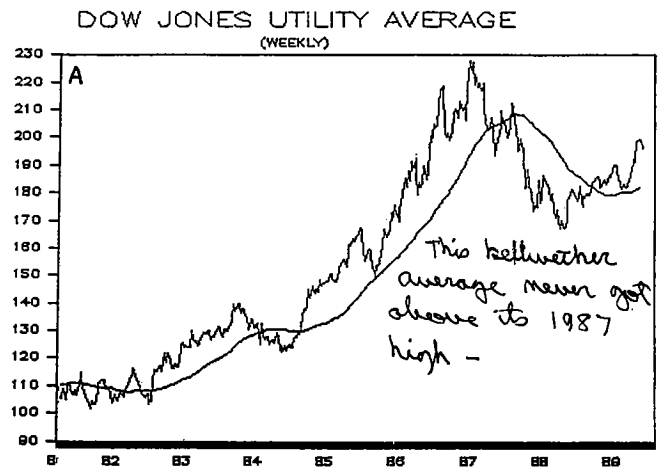
* *

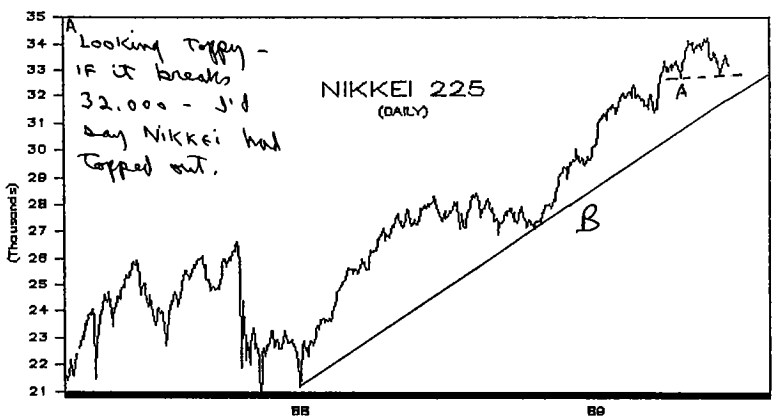
Box score on the S&Ls: So far they have lost a total of $44 billion in deposits, $28.5 billion of that in the fourth quarter of '88. In May, the outflow dropped to $2.5 billion.

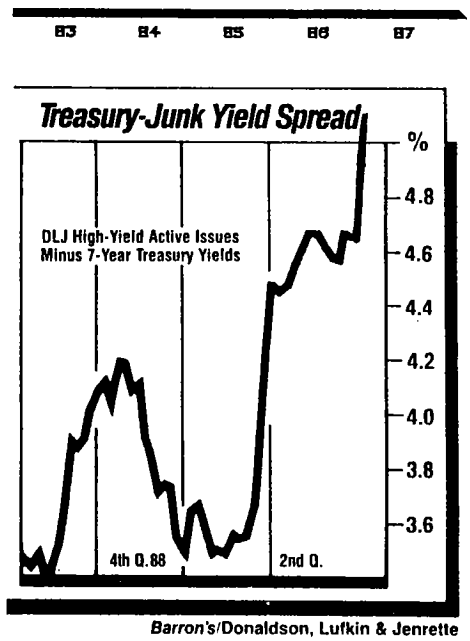

JAPANESE REAL
NET EXPORTS
This chart is a shocker!
Japan's exports plunging?!
Mar @ -404.9

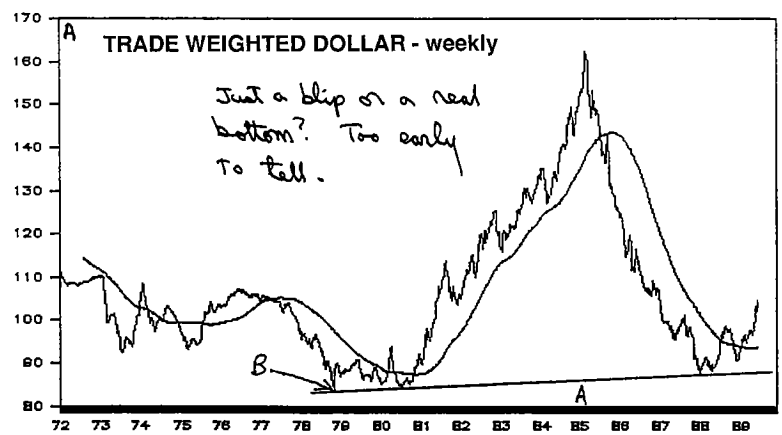

89:1Q @ $111.8 billion
US CORPORATE NET
INTEREST PAYMENTS
What happens when a recession hits?!
B

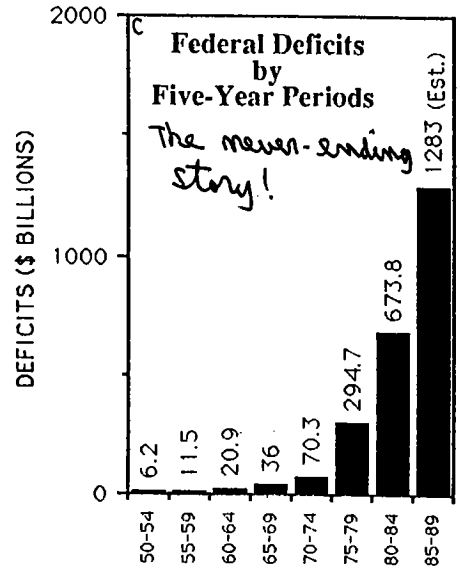

A
GOLD DIVIDED BY THE
D-J 20 BOND AVERAGE
When this ratio declines it's an indication of deflation.

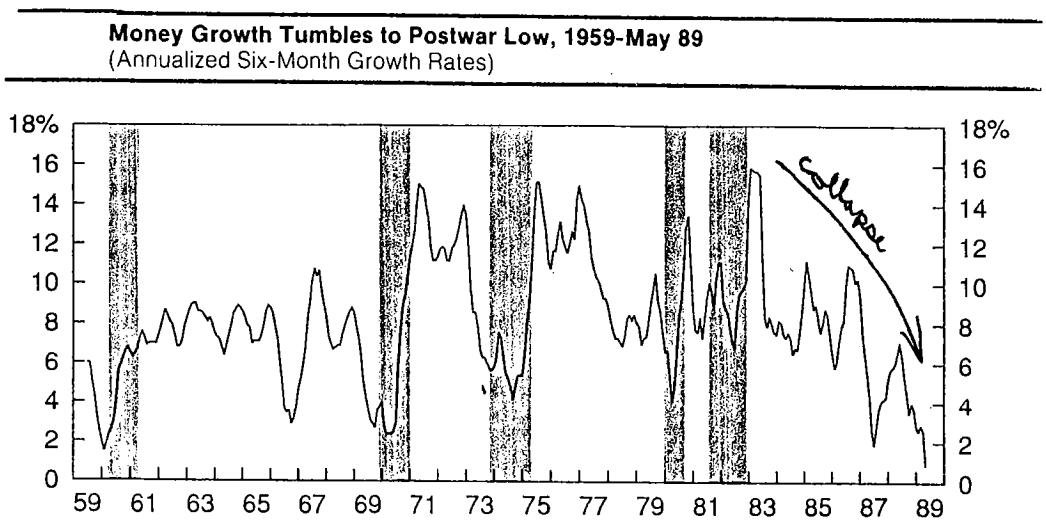

DOW JONES UTILITY AVERAGE
(WEEKLY)
A
This bellwether average never got above its 1987 high -


A
Looking Topply - IF it breaks 32,000 - I'd say Nikkei had Topped out.
NIKKEI 225
(DAILY)
(Thousands)
A
B

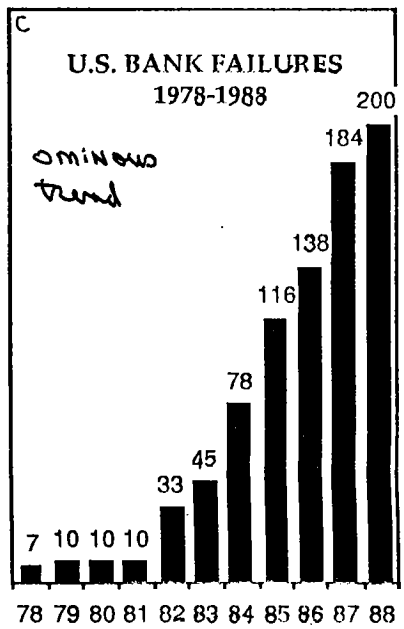

Treasury-Junk Yield Spread
DLJ High-Yield Active Issues
Minus 7-Year Treasury Yields
%
4.8
4.6
4.4
4.2
4.0
3.8
3.6
4th Q.88
2nd Q.
Barron's/Donaldson, Lufkin & Jenrette

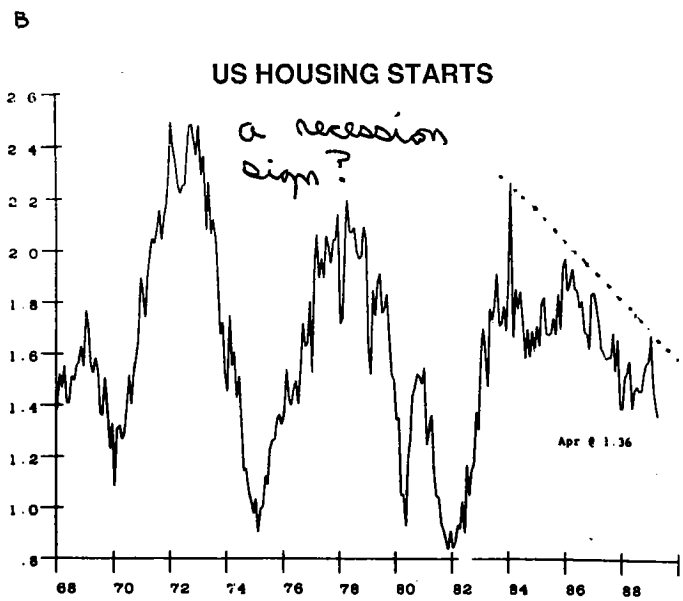

A
TRADE WEIGHTED DOLLAR - weekly
Just a blip or a real bottom? Too early To tell.
B
A

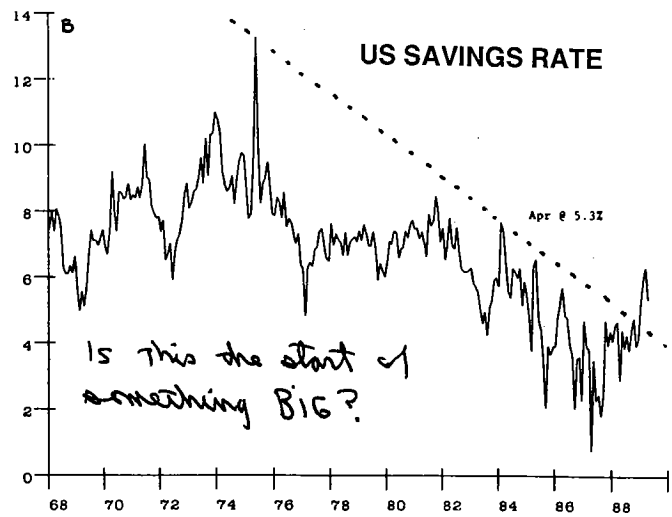




Note: Shaded regions denote recession periods.







Charts marked with an "A" courtesy of Paul Eldridge of Howard Ruff's Target publications. Charts marked "B" courtesy of Ed Hyman of C.J. Lawrence. Charts marked "C" courtesy of John Pugley and the Common Sense Press.

* *

The divisor on the Dow is now 0.659, which makes the Industrial Average very volatile. A move of one point on any Dow stock moves the Average 1.5 points (as recently as May '86 the divisor was 0.956).

* *

Sport magazine picks the Minnesota Vikings to win the next Superbowl against the Houston Oilers. The mag also calls rocket-armed quarterback Billy Joe Tolliver (he went to San Diego in the second round) "the steal of the draft." I hope so.

* *

Signs of the Times: Last week a baseball card of Honus Wagner, sold for $52,000. It was one of only 100 existing Wagner cards. . . . Last week the American Rare Coin Fund paid $990,000 for a rare 1804 silver dollar. The group stated that "our fund feels that it represents a good long-term value." This was the highest price ever paid for a US coin.

* *

"The Arizona real estate market is in a freefall," according to the July 9 *San Diego Union*. And on a percentage basis, the Arizona S&L situation is worse than Texas. With only 11 S&Ls in the state (Texas had 204), five of the 11 are now insolvent. The repossessed assets at the Arizona thrifts at the end of '88 amounted to $1 billion.

* *

BMW and Mercedes-Benz beware. The word on Toyota's Lexus (price $35,000) and Nissan's Infiniti (price $40,000), both new luxury cars, is that they are fabulous (top speed 150 MPH on each) and will be very tough competition for the higher-priced German cars.

* *

A few of the Reagan "legacies" are sifting down to George Bush. Reagan literally ignored the S&L situation, and now George can't wait to get it put away. Then the HUD mess hit, and no one knows yet how much that is going to cost the American taxpayers. The Bush crew even has a term for the Reagan clean-ups -- they call 'em "pooper-scoopers." Reason for the Bush haste: if the problems hang around too long they are no longer Reagan problems, they become Bush problems.

* *

The great rock bands of the '60s keep going and making money. The Who are on a national tour now, and they will be netting $30 million ($6 million to go to charity). Next comes Mick Jagger and the Rolling Stones who are already guaranteed between $65 and $70 million for their big upcoming tour.

* *

Where does the "little guy" put his money? In mutual funds. But what type of mutual funds? Total assets of ALL mutual funds (end of April) were $497 billion. The biggest single category ($93 billion) was tax-exempt or partially tax-exempt funds (all but nine states exempt federal government bonds from state taxes). Of these $58 billion was in government bonds, and $35 billion was in muni bond funds. Then there was $79 billion in growth and income (stock) funds. By the way, total in money-market funds is now $327 billion (not included in the mutual fund figure above.)

* *

How do you keep track of "who's who" in the big money circles? Best way I know of is with *Manhattan* magazine and (for society) *W* magazine (and throw in *Vanity Fair* and *New York* magazine for good measure). The latest issue of *Manhattan* contains an article about the wild prices paid for art. The conclusion is the auction houses, with their worldwide publicity, have taken the play away from the private dealers, and this process has driven art to historic high prices. Whereas many major art purchases were formerly made in secret with the price of the purchase unknown, the auction prices are published immediately, and new record prices simply add fuel to the fire.

A second reason for the sky-high price phenomenon is massive creation of currency throughout the world. A third reason is that many newly-rich buyers (in contrast to the seasoned collectors) have come into the market. They love the publicity stemming from the purchases, and they are largely ignorant of the history of art prices.

* *

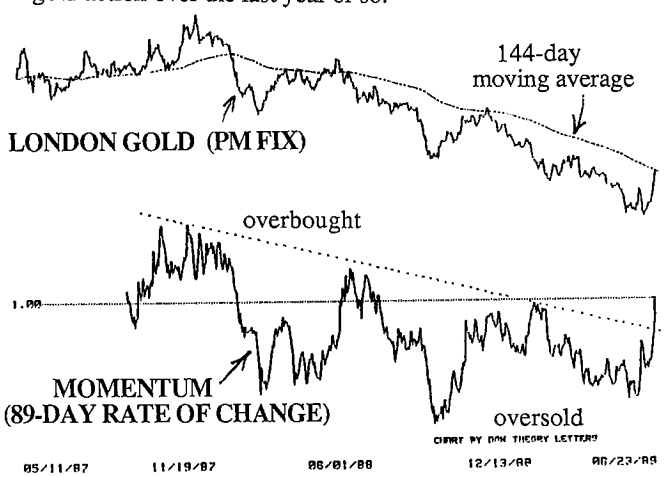
GOLD: (1) Gold gave a point & figure buy signal when the London PM fix hit 376. (2) Gold is at its highest level since April. (3) Gold in terms of the Japanese yen has reversed a downtrend that began in 1983. (4) My gold/common stock ratio hit a low of 200 on June 2. Since that time the ratio has been moving higher. One requirement of a true bull market in gold is that the gold/common stock ratio traces out a rising trend. It is a bit early to know whether this is happening, but since June 2 gold definitely has been outperforming common stocks. (5) My gold momentum chart (89-day rate-of-change) has turned bullish. (6) Sentiment toward gold remains largely skeptical and bearish.

For all these reasons, gold now looks better than it has for many months. But personally, I'm not celebrating, and my subscribers shouldn't either. After all, we've been buying gold coins on a monthly fixed-dollar amount basis. And as far as I'm concerned, I wanted to accumulate as much gold under $400 as I could.

So whether gold now rises above 400 or drops back to 360 makes little difference to me. I'm in the collection business. I've been collecting Krugerrands, Maple Leafs, Coronas and American Eagles, and the more coins I can get for my monthly fixed-dollar amounts, the better I like it.

My daily chart of gold shows two interesting relationships. First, gold is sitting right on its 144-day moving average. The last two contacts with the MA turned gold down. Let's see if the same thing happens again. If it doesn't, that will be significant -- and bullish.

The second item is that gold has now reversed its downward momentum (see bottom of chart) and has pushed into the neutral zone (neither overbought nor oversold). But any gold strength from this area would be important. And observation: gold has had three good surges to the upside over the last three weeks. After each surge gold gave ground grudgingly. This is the exact opposite of the gold action over the last year or so.



LATE NOTES: The PTI keep pushing to successive new highs, which is it's way of saying that the undertone of the market remains bullish. It almost seems as if the PTI is saying, "Soft landing or recession, there isn't going to be either." If that's true (and I'm obviously not sure that it is) then I would also expect inflation to heat up again. Which is why I'm particularly interested in the gold charts at this time. If there's any hint of rising inflation, we should see it in the action of gold.

In the meantime, if you have bonds, sit with them. If you have stocks sit with them. If you have money market or muni cash funds sit with them. All areas appear strained, but I don't see any obvious trend changes yet. To put it succinctly, "Don't do something, just stand there."

June 30 DJIA 2440.06; PTI 3087; A-D Ratio -8.25
July 7 DJIA 2487.86; PTI 3114; A-D Ratio -7.46
Current Dow Yield: 3.63; Dow P/E: 10.8
Dow Book Value: 1009; Dow 200-day MA: 2268
DowPow: 939
Percentage of undervalued blue-chips: 17%

NEXT MAILING: Wednesday, July 26